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Application of Reasonable Cause To Employers Using Third-Party Processors TR-45-39-95

This is in reply to your request for advice on whether an employer has reasonable cause for abatement of the failure-to-deposit penalty under section 6656 of the Internal Revenue Code where a third party (the Processor) prepared the payroll, received funds from the employer's bank account, but failed to timely deposit the funds.

You have informed us that, under your present practice, the section 6656 penalty may be abated if an employer relinquishes funds to a Processor in sufficient time for the Processor to make the deposit. This practice is reflected in IRM (20)683, Reporting Agent Mishandling (7-27-92) (The Penalty Handbook), which addresses a failure by a Processor that is referred to as a "Reporting Agent." A Reporting Agent may submit federal tax deposit information by magnetic tape for the clients as described in Rev. Proc. 89-48, 1989-2 C.B. 599.[1]

IRM (20)683 provides that the employer will not be penalized regardless of the Reporting Agent's reason, if any, for the failure to deposit timely.[2] Although it is not stated in the IRM, the provision is based on the belief that reliance on a commercial payroll processor for making deposits should be treated the same as reliance on a practitioner for advice on questions of tax law. IRM (20)333.7, Relied on the Advice of a

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[1] A Reporting Agent is permitted to use magnetic tape only if it is depositing for a minimum of 200 clients. An employer authorizes the Reporting Agent by filing Form 8655, Reporting Agent Authorization. Also, a Reporting Agent may be authorized to sign and file Form 941, Employer's Quarterly Federal Tax Return and Form 940, Employer's Federal Unemployment Tax Return as provided in Rev. Proc. 94-18, 1994-1 C.B. 580, and Rev. Proc. 93-46, 1993-2 C.B. 545, respectively.

[2] Prior to IRM (20)683, the Internal Revenue Manual did not address whether reliance on a commercial payroll processor provides reasonable cause.

Competent Tax Advisor (7-27-92), provides for abatement where a taxpayer relies on a practitioner for such advice.

Questions

Your principal question is as follows:

1. Has the "reliance on a practitioner" reasonable cause criteria been properly applied in IRM (20)683, when an employer timely provides the Processor with the funds necessary to make the payroll deposit, but the Processor fails to timely deposit the funds.?

The following situations are examples of the failures you are concerned with:

In Situation 1, an employer, A, engages a Processor to make its federal tax deposits. A has a federal tax deposit of $30,000 due on January 5. On January 3, A transfers $30,000 to the Processor. The Processor misplaces A's information and does not make the tax deposit until January 6. On May 18, A receives a notice showing a failure-to-deposit penalty of $600 (2 percent of the $30,000 deposit liability) for the late deposit made on January 6. A requests in writing that the Service waive the penalty because its funds were transferred to the Processor in sufficient time to make the deposit.

In Situation 2, the facts are the same as in Situation 1 except that the Processor's equipment is damaged by a natural disaster and, as a result of that damage, the deposit is not made until the equipment is restored on January 9. A requests in writing that the Service waive the penalty.

You also ask the following questions:

2. Has an employer met its Federal tax deposit obligation by timely relinquishing funds to a Processor?

3. Can an employer legally delegate the responsibility to make a timely federal tax deposit to a Processor (and thereby avoid being penalized for an untimely deposit)?

Responses

Our responses are as follows:

1. IRM (20)683 conflicts with U.S. v. Boyle, 469 U.S. 241 (1985). The employer should have reasonable cause for the failure only if the Processor has what amounts to reasonable cause for the failure.

2. The relinquishment of funds to a Processor does not constitute a deposit of tax. An employer remains liable for the payment of tax until the funds have been placed in the control of either Treasury or Treasury's authorized agent.

3. An employer's decision to use a Processor has no effect on the employer's responsibility to make a timely federal tax deposit. Even where a Processor is authorized to act pursuant to section 3504 of the Code (and, thereby, is treated as the employer for federal employment tax purposes), the employer remains subject to any penalty resulting from the Processor's failure.

Discussion

Background

There are two systems for making deposits: the Treasury Tax & Loan (TT&L) depository system and the TaxLink system.[3] Under the TT&L depository system, an employer or its agent delivers cash, check (under certain conditions) or a money order to a TT&L depository. Also, the employer or its agent may instruct its bank to initiate an electronic funds transfer (EFT) to the TT&L depository. A TT&L depository is an agent of the Treasury and is charged for delays in transferring funds to Treasury's account under its agreement with Treasury. The TT&L depository system is authorized by section 6302(c) of the Code.

Under TaxLink an employer or its agent instructs a financial institution to initiate an EFT to Treasury's account. The financial institution is either Treasury's authorized financial agent or the employer's (or the agent's) own bank. If the employer or its agent uses Treasury's authorized financial agent, the transaction is referred to as a debit transfer. If the employer or its agent uses its own bank, the transaction is referred to as a credit transfer. The financial institution will initiate the transfer with an automated clearing house (ACH) or the Federal Reserve's FedWire system. TaxLink is authorized by section 6302(h) of the Code and the underlying regulations.

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[3] TaxLink is an electronic remittance processing system used by the Service to accept an EFT of a federal tax deposit. See, Rev. Proc. 94-48, 1994-29 I.R.B. 31, as clarified, modified and amplified by Rev. Proc. 94-48A, 1994-52 I.R.B. 20.

When is an employer relieved of liability for making a payment of tax?

In the TT&L depository system, a deposit is made when cash, check (under certain conditions) or a money order is delivered to the TT&L depository or when an EFT is credited to the account of the TT&L depository.

In the TaxLink system, a deposit is made by a debit transfer when funds are removed from the employer's account pursuant to the instructions of Treasury's authorized financial agent even if Treasury's agent then misroutes those funds. Section 31.6302-1T(h)(7)(i) of the Regulations for Employment Taxes and Collection of Income Tax at the Source. A deposit is made by a credit transfer when the EFT is credited to Treasury's account. Section 31.6302-1T(h)(7)(ii). Therefore, a deposit is not made if the employer's financial institution, the ACH, or the FedWire system misroutes the funds.

Whether an employer has reasonable cause for a failure to deposit timely on the grounds that the employer's agent caused the delay

In general

The issue of whether reliance on a third party provides reasonable cause for a taxpayer's failure to act timely was addressed in Boyle, which concerns the section 6651 penalty for failure to timely file a tax return. The Court held that an estate subject to the section 6651 penalty where the estate's attorney failed to mail the estate tax return timely.

In Boyle, an executor engaged an experienced attorney specializing in probate matters to handle an estate and to prepare an estate tax return that was due June 14, 1979 (nine months after death). The executor cooperated fully with the attorney and provided him with all relevant information and contacted the attorney a number of times during the spring and summer to inquire about the progress of the estate and the preparation of the return. When the executor called the attorney on September 6, 1979, the executor was informed that the return was overdue. The attorney failed to mail the return due to a clerical oversight in omitting the filing date from the attorney's calendar. The executor and the attorney met on September 11 and the return was filed on September 13.

The Court took notice of the fact that the government has millions of taxpayers to monitor and the system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Prompt payment of taxes is imperative to the government which should not have to assume the burden of unnecessary ad hoc determinations.

The Court recognized that reliance by a lay person on a lawyer is common but stated that reliance cannot function as a substitute for compliance with an unambiguous, precisely defined duty to file a return within nine months. Congress has placed the burden of prompt filing on the executor, and not on some agent or employee of the executor.

The Court distinguished the situation where a taxpayer relies on erroneous professional tax advice concerning a question of law. The Court allowed that when an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a tax liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern an error in the substantive advice of an accountant or attorney. By contrast, the Court stated, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due. (IRM (20)333.7 is consistent with Boyle in this regard.)

The reasoning of Boyle applies to the section 6656 penalty and a Processor's failure to deposit timely. Under Boyle, reliance on a Processor, by itself, does not provide reasonable cause regardless of the care with which the employer chooses a Processor. Providing funds to a TT&L depository or instructions for an EFT under TaxLink is an unambiguous, precisely defined duty that the employer is capable of performing on its own. Accordingly, in Situation 1, the Processor's misplacement of A's information does not provide A with reasonable cause for the failure to deposit timely.[4] However, in Situation 2, A has reasonable cause for the failure because the Processor, itself, has what amounts to reasonable cause for the failure - an equipment failure caused by a natural disaster.

Failure caused by the financial institution initiating an EFT

Although an employer remains liable for the payment of tax where its financial institution misroutes an EFT, the employer is not penalized under section 6656 for the delay caused by the misrouting if the requirements of Rev. Rul. 94-46, 1994-29 I.R.B. 10, are met. Under Rev. Rul. 94-46 the employer must provide evidence that (1) it provided the financial institution with timely and correct instructions for the EFT, and (2) it had

[4] See also, Rev. Proc. 89-48 which warns Reporting Agents experiencing systematic problems in producing a magnetic tape to submit payment to a TT&L depository by preprinted form instead of the magnetic tape. The revenue procedure explains that the taxpayer may be subject to penalty and interest if the deposit is not received timely. Rev. Proc. 89-48 at section 3.03.

sufficient funds to cover the deposit in the account from which the EFT was to be made.[5]

Rev. Rul. 94-46 does not require that an employer use Treasury's authorized financial agent (that is, make a debit transfer) to have reasonable cause. In a debit transfer the payor's funds are accessed by the payee's agent. A payor may reasonably decide to transfer funds only from an account that its agent controls.[6]

Even though the employer's financial institution is acting on behalf of the employer when it initiates a credit transfer, the employer's reliance on its financial institution (as well as on the ACH and the FedWire system to complete the transfer) is reasonable for two reasons. First, an employer cannot have an EFT initiated without using a financial institution. This contrasts with the executor in Boyle who could mail an estate tax return.[7] Secondly, TaxLink is the Federal tax deposit system preferred, if not required, by the Government.

As to this second reason, TaxLink is the required Federal tax deposit system for the nation's 821 largest depositors (in dollar volume) starting in January of 1995. See, section 31.6302-1T(h)(1)(ii)(A) of the regulations. Also, the Government prefers that all employers voluntarily use the TaxLink system now. January was simply the start of a transition for virtually the entire federal tax deposit system. By 1999, 94 percent of the dollar amount of deposits will be required to be made by EFT using the TaxLink system or its successor. The volunteers serve

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[5] However, if the employer's financial institution repeatedly fails to transfer funds timely the penalty will not be abated even where the employer proves the financial institution is at fault. The Service has no way to encourage the taxpayer's financial institution to perform. In contrast, Treasury's financial agent may be penalized under the terms of its agreement with Treasury.

[6] Associations representing large corporate employers informed the Service that their members are wary of debit transfers. (Nevertheless, it is anticipated that smaller employers will favor the credit transfer option under TaxLink because there is no transmission charge to the employer.)

[7] Rev. Rul. 94-46 does not apply to an action that is not part of the EFT transmission process. For example, an employer may move funds from a general account to a "zero balance account" that is used specifically for making EFTs. The employer's instructions to move funds to the zero balance account might not be followed. Rev. Rul. 94-46 does not apply to this situation. Whether the employer has reasonable cause in this situation depends on whether the financial institution has what amounts to be reasonable cause for the failure to move the funds.

the interests of tax administration, as established in section 6302(h), by coming on board as soon as possible. The payroll information submitted through the TaxLink system is easier for the Service to process and the deposit will be made earlier than one made with a paper coupon or magnetic tape.

Effect of treating the employer's agent as an employer for purposes of the Code pursuant to section 3504

Under section 3504 of the Code, the Secretary is authorized to allow an agent who has control of or pays wages to perform the acts required by employers under the Code. For example, an agent filing a return files one return under its own name and Employer Identification Number for all of its clients.[8] Except as the Secretary provides, all laws, including penalties, that apply to the employer, shall apply to the agent.[9] However, the employer shall remain subject to such laws except as the Secretary provides. The regulations have not provided any exception. Because the agent is recorded as the employer in the Service's Business Master File, collection notices would be sent to the agent. However, if the Service cannot collect from the agent, it may assess the employer. Accordingly, regardless of any agreement between an employer and a Processor, including one authorized pursuant to section 3504, the employer remains responsible for paying tax and subject to the section 6656 penalty.

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[8] See, section 4 of Rev. Proc. 70-6, 1970-1 C.B. 420, which implements section 3504. An agent is authorized by Form 2678, Employer Appointment of Agent.

[9] In contrast, the Reporting Agent described on page 2 cannot be penalized for a failure made while acting on behalf of an employer. While the Reporting Agent may be authorized to receive notices and other tax information from the Service as well as to deposit taxes and to sign and file returns, it does not become an employer for federal tax purposes. For example, a Reporting Agent filing by magnetic tape files a separate return for each of its clients. The return is a composite consisting of the following:

(1) the payroll information for a client on the magnetic tape;

(2) the transmittal for the magnetic tape (Form 4996), which contains the Reporting Agent's signature verifying the payroll information; and

(3) Form 8655, in which the client authorizes the Reporting Agent to sign and file a return for the client.

We hope that this letter addresses your concerns. If you have any questions please call John Moran or Vince Surabian at 622-4940.

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(signed) RUDOLF M. PLANERT

By_____
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